Internal Revenue Service

memorandum

CC:TL:Br3
DAMustone

date: APR 20 1989

to: District Counsel, Hartford NA:HAR

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: Technical Advice - [redacted] (TL-N-5816-89).

It has been requested that we provide technical assistance with respect to the above taxpayer. The issue involved is reported in the current CEP Tracking Report. It is our understanding that there are no ISP issues in the subject taxable years worth designating for litigation.

ISSUE

Whether the taxpayer properly deducted in the [redacted] taxable year, a $[redacted] contribution made to a Voluntary Employees Beneficiary Association (VEBA) Trust at the end of that year to fund holiday pay benefits in future years.

CONCLUSION

We believe that it would be appropriate to set up and litigate this issue in the circumstances involved here.

FACTS

On [redacted], [redacted] ([redacted]) established a VEBA through which benefits under its [redacted] Pay Plan would be funded. Under the Plan, benefits are provided to eligible employees for certain specified holidays. The Plan apparently specified that [redacted] was to make an initial contribution to the Trust in [redacted]. On [redacted], a contribution of $[redacted] was made to the Trust. At that time, the Taxpayer had projected that the annual cost of providing plan benefits would be approximately $[redacted]. It was also determined that the earnings on the $[redacted] contribution would likely be more than sufficient to cover annually the projected benefit expenditures. In short, as a result of the subject contribution, the Plan was effectively fully funded for the foreseeable future.

The taxpayer apparently uses the accrual method of accounting. It fully deducted the $[redacted] contribution, together with the $[redacted] it expended in the [redacted] taxable year for holiday

pay, on its return for that year. The Examination Division proposes to disallow most of the VEBA contribution.1/

DISCUSSION

At the outset, it should be pointed out that Examination apparently does not question that the subject contribution satisfied the "all events" and economic performance tests under I.R.C. § 461, and for good reason. With respect to the former, because the contribution was irrevocable, there is no question that the liability was fixed and the amount thereof (i.e., the amount of the contribution) is determinable with absolute certainty. See, e.g., Treas. Reg. § 1.461-1(a)(2). In regard to the latter, the applicable regulations provide that for those welfare benefits funded through a trust, economic performance, for purposes of § 461(h), occurs in the year in which the contribution is made. See, e.g., Treas. Reg. §§ 1.461(h)-4T (Q&A-1), 1.419-1T (Q&A-10(d)). Accordingly, in this case, economic performance occurred in the year for which the deduction was claimed - [redacted].

Nevertheless, the contribution involved can be challenged on the basis that it creates an asset or economic benefit for the taxpayer which lasts substantially beyond the tax year which must, under I.R.C. § 162, be capitalized. See, e.g., Iowa-Des Moines National Bank v. Commissioner, 68 T.C. 872, 878 (1977), aff'd 592 F.2d 433 (8th Cir. 1979); Florida Publishing Co. v. Commissioner, 64 T.C. 269, 280 (1975), aff'd per curiam 552 F.2d 367 (5th Cir. 1977); Spritzer v. Commissioner, T.C. Memo. 1988-347. See also § 1.461-1(a)(2). In this regard, because the earnings alone on the $[redacted] are expected to cover plan benefits into the foreseeable future, [redacted] has effectively created a reserve of indefinite duration. At the same time, regardless of whether the VEBA funds are refundable or not, the reserve provides a direct and substantial benefit to the taxpayer by virtue of the fact that the holiday pay it has apparently promised its employees is being paid through the VEBA. Accordingly, the subject contribution should have been capitalized, and not currently deducted as was

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1/ On December 1, 1986, the Service issued VEBA Audit Guidelines for the years ending on or before [redacted]. (A copy of the Guidelines is attached hereto for your convenience.) These Guidelines provide various tests for determining whether such contributions (or any portion thereof) will be presumed to be reasonable, and hence, entitled to the automatic I.R.C. § 7805(b) relief provided for under the regulations. See Treas. Reg. § 1.419-1T (Q&A-10(c)). In proposing to allow a deduction for prefunding to the extent of [redacted] percent of the costs for [redacted], Examination is following these Guidelines. See Explanation of Items (Form 886-A), at 3-4. We believe that this is an acceptable application of the Guidelines.

done here.[2/] See also Anesthesia Service Medical Group, Inc. v. Commissioner, 85 T.C. 1031, 1045-46 (1985), aff'd 825 F.2d 241 (9th Cir. 1987).

However, while we generally agree with the course of action proposed here, we do have some specific reservations with respect to the contents of the Form 886-A which we would like to bring to your attention. First, we disagree with the statement that the deduction of the amount actually paid in [redacted] for holiday pay, together with the $[redacted] contribution, amounts to "a double deduction." See id., at 2. On the contrary, the former amount represents the actual costs for [redacted], and therefore, was properly claimed as a deduction for that year. The subject contribution, on the other hand, is intended to fund plan benefits which will be provided in later years. Accordingly, there is no duplication of expenses and consequently, no double deduction. Second, there is a slight error in the calculation of the proposed adjustment. See Explanation of Items, at 4. Specifically, [redacted] percent of the costs for [redacted] ($[redacted]) is $[redacted], and not $[redacted] as set forth in the Conclusion on the Form 886-A. Thus, the actual disallowance should be $[redacted].

If you need any further assistance in this matter, please contact David Mustone of this Division at (FTS) 566-3407.

MARLENE GROSS

By: Sarah A. Hall
SARAH A. HALL
Employee Plans Litigation
Counsel
Tax Litigation Division

Attachment:
VEBA Audit Guidelines.

2/ A similar issue was presented in Moser v. Commissioner, T.C. Memo. 1989-142, in which the court sustained the deductibility of contributions made to a VEBA for benefits to be provided in the future. The case is distinguishable, however, since the court's analysis focused strictly on the excessiveness of the contribution. A similar issue is also presented in [redacted], which is currently pending before Judge [redacted] for decision. It is hoped that the decision in that case will provide clearer guidance as to the application of capitalization in this context.